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No. 541

In the Supreme Court of the United States

OCTOBER TERM, 1932

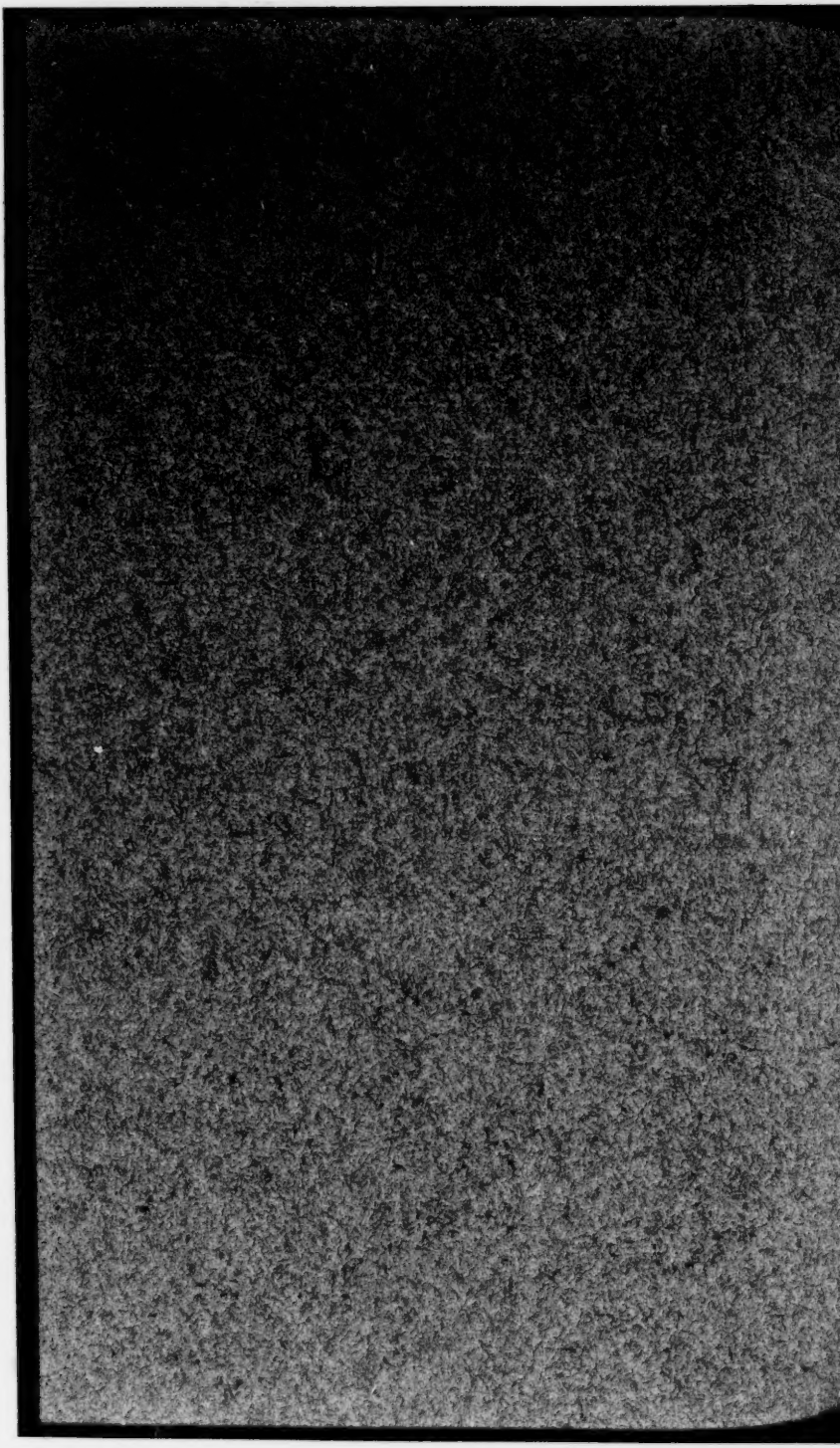
DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

A. T. JERGINS TRUST

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER



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OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 115–124) is reported in 22 B. T. A. 551. The opinion of the Circuit Court of Appeals for the Ninth Circuit (R. 182–187) is reported in 61 F. (2d) 92.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered September 8, 1932. (R. 187.) The petition for a writ of certiorari was filed December 8, 1932, and was granted January 16, 1933. (R.

190.) Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. May the United States tax income of a private association derived from the sale of oil and gas produced under an oil and gas lease of land owned by the City of Long Beach, California, the land having been acquired originally by the city, together with other lands, for the purpose of furnishing water to its inhabitants?

2. In determining net income under the Revenue Act of 1921, may capitalized expenses for drilling and developing oil wells be deducted from the gross income as depreciation allowance?

STATUTES AND REGULATIONS INVOLVED

These are set forth in the Appendix, *infra*, pp. 21–24.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 98–115) may be summarized as follows:

1. *As to the lease:*

The taxpayer is an association which was organized in April, 1922, under a declaration of trust executed pursuant to the laws of California. It was created for the purpose of entering into an oil and gas lease with the City of Long Beach, California, a municipal corporation. (R. 98.)

The charter of the City authorized it to acquire and own its water system and to purchase, hold,

lease, use, and enjoy property of every kind and description and to control and dispose of the same for the common good. (R. 98.)

Prior to 1911 the City had obtained its water supply from two or more independent water companies. The mains of these companies were maintained in an unsanitary fashion and could not resist sufficient pressure to enable the fire department to fight fires. (R. 98–99.) Under these conditions the City acquired from the water companies 600 acres of land and their equipment and mains. The land has since been used by the City for the purpose of a water plant and for other purposes. It was occupied in part by about 60 tenants (in addition to the tenants under the oil and gas leases) holding under leases or permits from the City. The businesses of these tenants include airplane repair, hangars for aircraft, oilwell supplies, telephone, storage plants, cracking plants, oil-skimming plants, dehydration plants, gasoline absorption plants, and farming. Such leases and permits were of a temporary nature and could be terminated on short notice, and were made subject to the right of the City to use the property for water purposes. (R. 99–100.)

In connection with the water system the City employed in 1922, 1923 and 1924 about fifty men, whose headquarters were on the 600 acres. (R. 99.)

In 1922 the City made an oil lease to the respondent of about 140 acres of the water system property.

(R. 100.) The lease provided, among other things, that no drilling should be done in certain areas without consent of the city manager (R. 101.); that the lessor reserved the right to use the land for agricultural, grazing, and such other purposes as it might deem necessary, in so far as such use would not interfere with any of the rights or necessary operations of the respondent (R. 102); that respondent would protect all the works of the lessor and any stored water on the lands against damage (R. 102–103); that all taxes imposed by the State of California or the United States, or any subdivisions of either, upon the lands should be paid in proportions of 40% by the lessor and 60% by the respondent (R. 44, 56, 106).[1]

In connection with the operation of the lease the City employed an oil engineer, whose duty it was to see that the respondent performed its contractual duties and that the City got its share of the oil and gas. The oil was sold under a joint contract between the City and respondent, as provided in the lease. The City kept a man on the leased property to keep the Superintendent of the Water Department informed of the respondent's activities. Conferences between city authorities and the respondent were generally held whenever a new well was to be located. The purpose of these prac-

[1] The full text of the lease was annexed to the petition to the Board of Tax Appeals. (R. 33–58.) The pertinent parts are quoted in the findings of fact made by the Board. (R. 100–108.)

tices was that the City might secure the maximum amount which could be obtained from its share of the oil and gas. (R. 109.)

All of the taxpayer's gross income for 1922 was derived from oil and gas produced under the lease. In 1923 and 1924 the amounts of $985,790.34 and $1,935,376.82, respectively, were derived from the same source. (R. 109–110.)

2. *As to deductions for depreciation:*

During 1922 the respondent expended $59,376.86 for physical equipment and $102,508.85 for wages, fuel, repairs, hauling, etc., in connection with development and drilling. (R. 113.) The full amount of these expenses, $161,885.81, was capitalized in the determination of the deficiency for the year 1922. (R. 114.)

During the year 1923 respondent expended $260,313.62 for physical equipment and $431,393.11 for wages, fuel, repairs, hauling, etc., in connection with development and drilling. The full amount, $691,606.73, was capitalized in the determination of the deficiency for the year 1923. (R. 114.)

During the year 1924 the respondent expended $303,244.69 for physical equipment and $452,226.75 for fuel, repairs, hauling, etc., in connection with development and drilling. The full amount, $755,-471.44, was capitalized in the determination of the deficiency for 1924. (R. 114.)

The petitioner allowed depreciation only on the amounts expended for physical equipment, and

added the drilling expenses to sums recoverable through depletion. (R. 114.) He computed respondent's depletion allowance for 1924 based upon cost of leaseholds and development cost, plus discovery value, at the amount of $1,228,864.99, and allowed a deduction of $771,982.99. (R. 114–115.)

The petitioner determined deficiencies in income tax for the years 1922, 1923, and 1924 in the respective amounts of $1,126.62, $3,368.92, and $61,458.34. (R. 97.)

The Board of Tax Appeals held (1) that the respondent's income derived from the lease was not exempt from Federal income and profits taxation (R. 118), and (2) that expenditures for fuel, wages, repairs, hauling, etc., in connection with the drilling of oil and gas wells were capital expenses, recoverable through depreciation rather than depletion (R. 123).

The respondent appealed from the Board's decision that it could be taxed for earnings derived under the lease. (R. 145.) The petitioner appealed from the Board's decision permitting a depreciation allowance as to capitalized expenses for drilling costs and development which he had treated as returnable only through a depletion allowance. (R. 153.)

The Circuit Court of Appeals for the Ninth Circuit held that the respondent was an instrumentality of the City and could not be taxed by the United

States (R. 187), and thus found it unnecessary to decide the question of allowance of drilling and development expense.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the respondent's income derived from the sale of respondent's share of oil and gas ~~purchased~~ produced under a lease of land owned by the City of Long Beach, California, may not be taxed by the United States.

2. In reversing the decision of the Board of Tax Appeals holding that such income is subject to Federal taxation.

3. In failing to hold that respondent's capitalized expenses for drilling and development were recoverable only through a depletion allowance.

4. In reversing the determination of the Commissioner of Internal Revenue assessing a deficiency.

SUMMARY OF ARGUMENT

Decision in this case is not controlled by *Burnet* v. *Coronado Oil & Gas Co.*, 285 U. S. 393, and *Gillespie* v. *Oklahoma*, 257 U. S. 501. The tax upon the income of the respondent, a private trust which had leased lands from the City of Long Beach, California, does not affect directly or indirectly the performance by the City of any governmental function.

Taxation of the respondent's income does not directly interfere with the performance of any

governmental function. The action of the City in leasing its oil lands and deriving royalties therefrom was proprietary and nongovernmental. The lands involved were not needed for any governmental purpose and the lease had no relation to the performance of any governmental purpose. Even if the leased lands were held for future use in connection with the City's water supply, the supplying of water to the inhabitants of a city is not a governmental function.

Immunity of the respondent is not required because a Federal tax upon it would have any substantial indirect effect upon the performance of governmental functions. There is no showing that the income received by the City under the lease was devoted to any such function, and no presumption can be indulged that it was so devoted. Since the taxpayer is seeking immunity, it has the usual burden of establishing the facts upon which immunity must rest. It has failed to sustain the burden.

II

The decision of the Board of Tax Appeals that capitalized sums expended for drilling and development were returnable to the taxpayer through a depreciation allowance was erroneous, for the reasons set forth in Point I of the Government's brief in *Dakota-Montana Oil Co.* v. *United States*, No. 434. In the event that the judgment of the court

below is reversed, the Court should also reverse the decision of the Board of Tax Appeals upon this phase of the case.

ARGUMENT

I

THE RESPONDENT'S INCOME WAS NOT IMMUNE FROM FEDERAL TAXATION

The court below concluded that it was constrained to hold that the respondent was immune from Federal taxation upon its income derived from oil lands leased to it by the City of Long Beach principally because of the decisions of this Court in *Burnet* v. *Coronado Oil & Gas Co.*, 285 U. S. 393, and *Gillespie* v. *Oklahoma*, 257 U. S. 501. In the former this Court held that when Oklahoma, for the benefit of its public schools, leased its public lands, dedicated from the time of their acquisition to support of the public-school system, it exercised a function strictly governmental in character; accordingly, it was decided, no Federal tax could be levied on the income of the State's lessees, since such a tax, it was said, would amount to an imposition on the lease itself, which the Court held was one of the States's instruments of government. In the *Coronado case* this Court adhered to and applied its ruling in the *Gillespie case*, where the income of a lessee of Indian lands was held to be immune from State taxation, but in so doing clearly indicated its purpose to apply the doctrine of the

Gillespie case "strictly and only in circumstances closely analogous to those which it disclosed" (p. 398).

We believe that the court below has extended the rule thus limited and applied in the *Coronado case* to circumstances which bear no analogy to those in either the *Coronado* or the *Gillespie case*. In the instant case none of the factors which induced the Court to follow and apply the rule of the *Gillespie case* in the *Coronado case* are present. No governmental instrumentality was subjected to Federal taxation; no strictly governmental function has been impaired.

It is axiomatic that the implied constitutional prohibition against taxation by the Federal Government of agencies or instrumentalities of a State is limited to protecting the States, their agencies and instrumentalities, in the performance of their strictly governmental functions against substantial interference through taxation by the Federal Government. It is settled that a tax offends against that limitation only if it is imposed directly upon a governmental instrumentality of the State, or if, though not so imposed, its effect is to place a substantial burden upon the exercise of a governmental function. *Willcuts* v. *Bunn*, 282 U. S. 216; *Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514, 525.[2]

[2] This proposition is sustained by numerous other decisions of this Court, including *Fox Film Corp.* v. *Doyal*, 286 U. S. 123, 128; *Group No. 1 Oil Corp.* v. *Bass*, 283 U. S. 279, 282; *Alward* v. *Johnson*, 282 U. S. 509; *Educational*

As this Court said in *Indian Motocycle Co.* v. *United States,* 283 U. S. 570, 576, "* * * the immunity does not extend to anything lying outside or beyond governmental functions and their exertion * * *"; hence one claiming immunity must establish that the burden of the tax imposed upon him is a substantial burden upon the exercise of some governmental function. The immunity does not reach a nondiscriminatory tax on transactions that are merely related to governmental instrumentalities or functions. *Willcuts* v. *Bunn, supra,* pp. 227, 229.

A

The tax declared by the court below to have been illegally assessed was an income tax assessed upon the income of a lessee of lands theretofore acquired by a municipality in connection with the acquisition of the properties of two or more independent water companies whose service in furnishing water to the inhabitants of the City had not been satisfactory. Much of the property thus acquired was

Films Corp. v. *Ward*, 282 U. S. 379; *Shaw* v. *Oil Corp.*, 276 U. S. 575; *New Brunswick* v. *United States*, 276 U. S. 547; *Choctaw O. & G. R. R. Co.* v. *Mackey*, 256 U. S. 531; *Ackerlind* v. *United States*, 240 U. S. 531, 536; *Gromer* v. *Standard Dredging Co.*, 224 U. S. 362; *Elder* v. *Wood*, 208 U. S. 226; *Baltimore Shipbuilding Co.* v. *Baltimore*, 195 U. S. 375; *Wagoner* v. *Evans*, 170 U. S. 588; *Thomas* v. *Gay*, 169 U. S. 264; *Central Pacific R. R.* v. *California*, 162 U. S. 91; *Salt Lake City* v. *Hollister*, 118 U. S. 256; *Forbes* v. *Gracey*, 94 U. S. 762; *Railroad Co.* v. *Peniston*, 18 Wall. 5; *Thomson* v. *Pacific Railroad*, 9 Wall. 579; *Veazie Bank* v. *Fenno*, 8 Wall. 533, 547; *Philadelphia* v. *The Collector*, 5 Wall. 720.

not presently required in connection with the business of water supply which the City took over from these public service corporations. It was therefore available, as property owned by the City but not presently needed, for such nongovernmental uses as might be most profitable, and leases to various tenants were made for various strictly private uses. The situation is the reverse of that presented in *Trinidad* v. *Sagrada Orden,* 263 U. S. 578, 582, in that the City instead of adhering to and advancing the purpose for which the lands were originally acquired, stepped aside from that purpose and devoted them to general business pursuits. Under these circumstances the mere fact that the lessor was a municipality does not render the tenant immune from taxation, for it is a matter of common knowledge that municipalities exercise functions which are purely proprietary as well as those which are strictly governmental. See *Vilas* v. *Manila,* 220 U. S. 345, 356. It will not suffice for the lessee, seeking exemption for itself from the payment of income taxes, to show that its income has been derived from lands leased from a municipal corporation. In order to prove the exemption it must also be shown that imposition of the tax upon the lessee's income will result in substantial interference with the performance by the City of some strictly governmental function. The record does not disclose the use to which the royalties paid the City were put; but assuming, in the absence of any show-

ing on the record, that they were devoted to governmental purposes, such use would not be sufficient basis for exemption of such receipts (*South Carolina* v. *United States,* 199 U. S. 437; *Olson* v. *North Dakota,* 33 F. (2d) 848 (C. C. A. 8th), appeal dismissed for lack of jurisdiction, 280 U. S. 528), and much less of the profits of the lessee.

Standing alone, a lease of lands for the extraction of oil is a purely private enterprise unrelated to any governmental function, and the mere fact that the municipality derives profit from the transaction does not exempt the lessee's profit from Federal taxation. See *South Carolina* v. *United States,* 199 U. S. 437. The situation at bar is not different from a case where a city leases vacant land to one who erects an office building thereon, or to a farmer for agricultural purposes. Certainly the income of the lessee would not be exempt from tax. In such cases the City is a mere proprietor engaged in business for profit and the individual dealing with the City under such circumstances should not be entitled to draw about him the cloak of immunity which was designed solely to protect the States and their agencies in the exercise of their governmental functions.

The mere fact that the City originally acquired the lands in connection with other lands acquired for water purposes does not require a different conclusion. The oil lease to the respondent had nothing to do with the supply of water. The land was,

in effect, segregated from the balance of the tract and devoted to other and wholly different purposes. Thus, even if, contrary to the fact, supplying water could be regarded as a governmental function, the tax upon the lessee of lands not then used for that purpose would have no connection with its performance. We submit that there is no principle by which a city, having provided itself with land not presently useful for strictly governmental purposes, can lease such land to private individuals or companies for an entirely different purpose and thus confer tax immunity of the kind now claimed.[3]

Even if it should be considered that the leasing of a portion of the tract originally acquired for the purpose of supplying water did not constitute a temporary abandonment of that use as far as these lands are concerned, it is clear that the present tax has no economic effect upon the performance of

[3] The record in the instant case illustrates the absurd consequences which might be produced if respondent's position were sustained. The land originally acquired by the City as a source of its water supply was in part leased to 60 tenants. (R. 99.) Although by provision for cancellation on short notice the City reserved the right to resume possession (R. 100), until cancelled there was no connection between the business of supplying water and the making of leases to such tenants. If the judgment of the court below is affirmed, it would seem to follow that these tenants of the City, who were engaged in such diverse businesses as oil-well supplies, dehydration plants, airplane repair, and farming, were governmental instrumentalities of the City, and that their income was immune from Federal taxation.

any governmental function of the City of Long Beach, for the supplying of water, while undoubtedly a "public" or "municipal" purpose, is not a strictly governmental function. Decisions of the California courts clearly indicate that the business of supplying water is not regarded as a governmental function. See *Davoust* v. *City of Alameda*, 149 Cal. 69, 72–73; *South Pasadena* v. *Pasadena Land, etc., Co.*, 152 Cal. 579, 593; *Morrison* v. *Smith Bros., Inc.*, 211 Cal. 36, 45; *Chafor* v. *City of Long Beach*, 174 Cal. 478, 483; *Marin Water, etc. Co.* v. *Town of Sausalito*, 168 Cal. 587, 594–595; *Sincerney* v. *City of Los Angeles*, 53 Cal. App. 440, 447.[1]

[1] The view of the California courts is supported by the weight of authority elsewhere. See *Blair* v. *Byers*, 35 F. (2d) 326 (C. C. A. 8th); *Winona* v. *Botzet*, 169 Fed. 321 (C. C. A. 8th); *Omaha Water Co.* v. *Omaha*, 147 Fed. 1 (C. C. A. 8th); *Canaran* v. *Mechanicsville*, 229 N. Y. 473, 476; *Wiltse* v. *Red Wing*, 99 Minn. 255, 260; *Lynch* v. *Springfield*, 174 Mass. 430; *Public Service Comm.* v. *Helena*, 52 Mont. 527; *Miller Grocery Co.* v. *Des Moines*, 195 Iowa 1310; *Pacific Paper Co.* v. *Portland*, 68 Ore. 120.

It is immaterial that part of the water distributed was used for fire protection, since there is no proof that the land here involved was used in connection with the storage or supply of water for that purpose. Nor is there any proof that the tax here imposed would in any way burden the City in providing fire protection for its inhabitants. Moreover, the proprietary aspect of the operation of the water system of a municipality is not affected by the circumstance that one of the uses of the system may be in connection with fire protection. *Miller Grocery Co.* v. *Des Moines*, *supra*, p. 1315; *Piper* v. *Madison*, 140 Wis. 311; *Blake-McFall Co.* v. *Portland*, 68 Ore. 126; *Aschoff* v. *Evansville*, 34 Ind. App. 25.

This Court in *Flint* v. *Stone Tracy Co.*, 220 U. S. 107, said (p. 172):

> It is no part of the essential governmental functions of a State to provide means of transportation, supply artificial light, water, and the like. * * *
>
> The true distinction is between the attempted taxation of those operations of the States essential to the execution of its governmental functions, and which the State can only do itself, and those activities which are of private nature.

See also *South Carolina* v. *United States*, *supra*, p. 462.

It is plain, therefore, that whether the leasing of lands to respondent be deemed a venture for profit unconnected with its proprietary business of supplying water or as a part of that business, still it was not connected with the performance by the City of any governmental function. Hence no direct interference with the performance of a function of government is involved, and, unless there is a showing of some indirect effect which interferes substantially with the performance of such functions, the tax must be upheld.

B

In *Burnet* v. *Coronado Oil & Gas Co.*, *supra*, the Court applied *Gillespie* v. *Oklahoma*, *supra*, to what it regarded as an analogous situation. In the *Coronado case* there was the combination of circumstances that the land leased had been dedicated

by the grant from the United States and the organic law of Oklahoma to the furtherance of a governmental function and that the proceeds of the leases were required to be paid into the school fund. The lands in the *Gillespie case* were held in trust for the Indians by the United States. The court therefore concluded that the leases were governmental instrumentalities. In the case at bar the City was free to devote its profits from the lease to any purpose, whether proprietary or governmental. So far as appears from the record, the functions of the City were not in any way affected by the tax on respondent's income.

The court below assumed that the City's income would be used for "municipal purposes" (R. 187) and it apparently considered that such use was sufficiently synonymous with use for strictly governmental purposes. We submit, however, that common knowledge of the many nongovernmental uses to which municipal funds are put, as well as the facts readily available as to the fiscal activities of the City of Long Beach, forbid resort to a presumption that the funds were devoted to purposes *strictly governmental*. The City of Long Beach has built and maintained an auditorium and meeting hall, a venture which the Supreme Court of California has held to have been undertaken in its proprietary, as distinguished from its governmental, capacity. *Chafor* v. *Long Beach*, 174 Cal. 478. The report of its auditor for the City's fiscal

years which embrace the taxable periods involved in this case show substantial expenditures for such municipal, but certainly nongovernmental, purposes as advertising, donations to charitable institutions, piers, waterworks, municipal market, wharves and docks, and support of a municipal band. See *Auditor's Annual Report, City of Long Beach, California, Fiscal Years Ending June 30, 1922, 1923, 1924.* Assuming for the purpose of argument, but not conceding, that devoting the proceeds of the lease to strictly governmental functions would support the exemption claimed in this case, a presumption that the funds were so used can not be indulged. It follows that in the absence of proof it was error to conclude that the tax upon the respondent's income imposed an indirect burden on strictly governmental functions, when, with equal assurance upon the basis of facts within common knowledge, it may be said that the City's income was devoted to nongovernmental activities.

The exemption of an instrumentality of one government from taxation by the other must be given a practical application, without an undue impairment either of the taxing power of the one or of the appropriate exercise of its functions by the other. *Susquehanna Co.* v. *Tax Commission (No. 1)*, 283 U. S. 291, 294; *Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514, 523, 524. Respondent has failed to show that any governmental function of the City of Long Beach has suffered or will suffer interference by reason of the Federal tax. This Court has indi-

cated that in this field of taxation, as in all others, one who seeks to escape the burden of a tax must show the facts which entitle him to relief. See *Willcuts* v. *Bunn, supra,* pp. 230, 231; see also *Phillips* v. *Dime Trust & Savings Bank,* 284 U. S. 160, 167; *Burnet* v. *Houston,* 283 U. S. 223, 227; *Niles Bement Pond Co.* v. *United States,* 281 U. S. 357, 361; *Reinecke* v. *Spalding,* 280 U. S. 227, 232.

II

THE DECISION OF THE BOARD OF TAX APPEALS AS TO DEPLETION WAS ERRONEOUS

There was also submitted to the Board of Tax Appeals the question whether the capitalized sums for drilling costs and development expense in connection with oil wells were returnable to respondent through a depletion or a depreciation allowance. (R. 113–115.) The petitioner had treated such sums as subject only to a depletion allowance, as provided in Sections 234 (a) (8) and 204 (c) (3) of the Revenue Act of 1924, as construed by Articles 223 and 225 of Treasury Regulations 62 and 65, *infra,* pp. 22–24. The Board held that they were subject only to depreciation allowance. (R. 120–123.) As the court below held that all of the respondent's income from oil wells was immune from tax, it found it unnecessary to consider or decide this question.

The precise question under the identical provisions of the Revenue Act of 1926 and Regulations thereunder is now before this Court in *United States* v. *Dakota-Montana Oil Co.,* No. 434, October

Term, 1932, and *Petroleum Exploration* v. *Burnet*, No. 448, October Term, 1932, which will be argued before this case. Our contentions on this question are fully set forth in Point I of our brief in No. 434, which, without burdening the Court with a repetition thereof, we adopt as our argument here. For reasons there stated we believe that the decision of the Board herein was erroneous on this point, and that, if this Court reverses the court below, it should also reverse that portion of the decision of the Board of Tax Appeals.

CONCLUSION

The decision of the Circuit Court of Appeals was erroneous, and its judgment should therefore be reversed.

If the judgment of the court below is reversed, the decision of the Board of Tax Appeals that the expenditures of respondent in drilling and developing are subject to a depreciation allowance, instead of a depletion allowance, should also be reversed.

Respectfully submitted.

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FEBRUARY, 1933.

APPENDIX

Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 254:

SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *.

SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * *

(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

* * * * *

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: * * *; such rea-

sonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee; * * *.

Revenue Act of 1924, c. 234, 43 Stat. 253, 267, 283:

[SEC. 213 (U. S. C., Title 26, Sec. 954) is substantially the same as Section 213 of the Revenue Act of 1921 above quoted.]

SEC. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * *

(7) A reasonable allowance for the exhaustion, wear, and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

* * * * *

(U. S. C., Title 26. Sec. 986.)

Treasury Regulations 62 (promulgated under the Revenue Act of 1921):

ART. 223. *Charges to capital and to expense in the case of oil and gas wells.*—Such

incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to the capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling nonproductive wells may at the option of the operator be deducted from gross income as a development expense or charged to capital account returnable through depletion and depreciation as in the case of productive wells. An election once made under this option will control the taxpayer's returns for all subsequent years. * * *.

ART. 225. *Depreciation of improvements in the case of oil and gas wells.*—Both owners and lessees operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223. The amount deductible on this account shall be such an amount based upon its cost (or fair market value as of March 1, 1913, if acquired prior to that date), equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown

to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation may for such property be based upon the length of life of the deposit. * * *.

Treasury Regulations 65 (promulgated under the Revenue Act of 1924):

[Article 225 is the same as Article 223 above, and Article 227 is like Article 225 above.]

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